# Reengineering Nonprofit Financial Accountability: Toward a More Reliable Foundation for Regulation

**By**

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## Abstract

Today, the annual IRS Form 990 tax filing is the principal annual disclosure mechanism of nonprofit organizations. Over time, considerable thought has been put into finding ways to improve access and use of the 990 Form, with only scant attention focused on whether the 990 is the right data source on which to build a system of nonprofit accountability. This paper takes a broader perspective, assessing not only the quality of the financial data and its availability, but also the entire financial reporting model. The paper begins with a framework for thinking about organizational accountability. It then examines the current structure of nonprofit financial reporting and contrasts it with alternative systems developed for publicly traded firms and credit unions. The paper concludes with recommendations for improving nonprofit accountability by reengineering the reporting and oversight systems in the sector.

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Over the past decade a number of major financial scandals have rocked the nonprofit world, including the conviction and imprisonment of the president of the United Way of America for embezzlement (Murawski 1995), the jailing of the head of the Foundation for New Era Philanthropy for perpetrating a vast investment fraud (Stecklow 1997), and the prosecution of leaders of the Episcopal and Baptist churches for theft (Greene 1995 and Fletcher 1999). If these crimes were not enough, ethical lapses have also hurt the credibility of the sector, including some that have occurred at the largest institutions. The ousting of the head of the National Association for the Advancement of Colored People (NAACP) over the improper use of funds (Greene 1995) and the forced resignation of the president of Adelphi University due to an excessively generous compensation package (Thornburg 1997) further tarnished the image of the sector and pushed the issues of nonprofit accountability, openness, and financial reporting onto the public agenda. For the first time in decades, the issue of the accountability of the nonprofit sector has surfaced and with it questions about the adequacy of the current reporting and oversight mechanisms.

The response of the nonprofit community to these challenges has been to focus on the accessibility of the existing of the IRS Form 990, the longstanding centerpiece of nonprofit accountability. In 1999, the IRS issued regulations requiring nonprofits to make available the last three IRS filings to anyone requesting them in person or by mail. These regulations have encouraged several nonprofit groups to provide summarized and scanned 990 forms via the World Wide Web.[1] In addition, the IRS has been making limited 990 information available in machine-readable form to researchers with the assistance of the National Center for Charitable Statistics (NCCS).[2]

As a financial reporting tool, the 990 Form is not without its critics, however. Numerous studies (Abrahmson 1995, Orend, O'Neill & Mitchell 1997, Qual990, 2000) have identified substantial inaccuracies in the data. NCCS has itself called for substantial revisions to the 990 Form to increase the quantity and improve the quality of information. Others have criticized the web-based nonprofit information providers for giving donors "the mistaken impression that the Forms 990 offer a fair presentation of the financial results of an organization" and for overly condensing the tax return information (Prives 2000). Peter Swords, head of the Nonprofit Coordinating Committee of New York, criticizes the current focus on "negative accountability," which only verifies that financial and business transactions are legal (Quality 990, 1999) and does not actually document that valuable services are being rendered.

The Form 990 is not the only weak link in this accountability system: The accounting systems in many nonprofits are in poor order. A large numbers of potential users of nonprofit financial reports are unsure what information is available and how to obtain access. Many users do not know how to read and interpret financial statements. The end result is predictable: Few users are able to conduct performance assessments of nonprofits and make informed decisions about future support or participation. Given the scope of these problems, we argue that the nonprofit community's future economic

[1] See Guidestar at: http://www.guidestar.org.
[2] To apply for data contact the National Center for Charitable Statistics (NCCS) at: http://nccs.urban.org/ or the Internal Revenue Service at: http://www.irs.gov/tax_stats/exempt.html.

success depends not only on the quality of its social and economic activities, but also on improving its internal accounting decisions and communication of its financial results to the external community.

These issues raise the difficult question that lies at the core of this paper: What would a new accountability and reporting system look like and who would benefit from a more reliable and relevant reporting system? Beyond simply locating precise breakdowns in the current system, the aim of this paper is to describe what reengineering of the nonprofit accountability system might entail. We proceed in four steps. In a first section, we present a financial reporting framework, including the values and structures inherent in such activity. In a second section, we describe the history of and current status of financial reporting in the nonprofit sector. In a third section, we consider alternative financial reporting systems in the United States and detail the Security and Exchange Commission's reporting system for publicly traded firms and the National Credit Union Administration's approach for credit unions. In a final section, drawing on best practices from other sectors, we provide recommendations for reengineering the nonprofit sector's financial reporting system.

## I. Theory of Financial Reporting

### *A. The Elements of a Financial Reporting System*

A first step in improving accountability in the nonprofit sector is understanding how financial reporting systems are intended to work. We begin with a model that captures the key elements of any such system (Figure 1). Adapted from a similar model developed for the business sector (Wilson 1995), the model has six components. Organizations conduct activities (*Organizational Activities*) that are reflected in the internal accounting system (*Accounting System*). Periodically, the organization prepares and disseminates financial statements to stakeholders (*Financial Disclosure*). The activities, accounting system, and financial disclosures may be examined by internal or external parties (*Oversight and Monitoring*) to ensure that the activities conform to existing contracts, the accounting records accurately reflect the activities, and the financial disclosures conform to any requirements. Stakeholders, such as investors, creditors, donors, clients, and government analyze the disclosures. Ideally, an analysis of the disclosure will allow stakeholders develop a performance assessment of the organization (*Performance Assessment*). The judgments that the stakeholders make about a particular organization influences their willingness to support or participate in these organizations in the future (*Decision about Support and Participation*). Because these decisions have financial implications, stakeholders are able to affect the subsequent activities of the organization. A closed system is thereby created: An organization's future support depends on not only its programmatic activities but also on its internal accounting decisions and ability to communicate its financial results to the stakeholder community.

This model includes two key groups: the organization and the user or stakeholder community. The organization relies on its internal accounting system to develop the financial information it *supplies* to its stakeholders. The stakeholders, in turn, create a *demand* for information for decision-making purposes. The types of information and performance assessments will vary based on the stakeholder’s needs and interests. Both the organization and the stakeholders can influence the financial disclosures that are provided and determine the degree of monitoring and oversight that occurs in the system.

In assessing financial reporting systems, it is therefore critical to consider the nature of the supply-demand relationship, as well as key elements of the system, including the internal accounting system, financial disclosure requirements, the characteristics of the user community, and oversight and monitoring mechanisms.

### *B. The Objectives of a Financial Reporting System*

To determine the effectiveness of a particular financial reporting system, it is important to understand its objectives. After the stock market crash of 1929, the US Congress, businesses, and individuals recognized the importance of a sound financial reporting system in sustaining commerce and the economy as a whole. The financial reporting system for publicly traded firms and, to a lesser extent, other US organizations reflect this experience. The policymakers have sought to design systems that provide information that is both *reliable* and *relevant*.

Today, an independent, nongovernmental entity, the Financial Accounting Standards Board (FASB), is responsible for setting financial accounting and reporting standards for business and nonprofit organizations in the United States, known as generally accepted accounting principles (GAAP).[3] It has defined reliability and relevance as follows: Accounting information is reliable if is verifiable, is free of error and bias, and represents faithfully events that occurred. To be relevant, accounting information must be capable of making a difference in a decision. Relevant information is timely, can help users make predictions, and helps confirm or correct users' expectations. To achieve these two qualities, the financial statements must also be comparable to other enterprises and be prepared consistently over time.

In its initial concept paper, the FASB elaborated on the objectives of the financial reporting system. To achieve the qualities of reliability and relevance, the disclosed information must allow present and potential users to:

1) make rational investment, credit, and similar decisions,
2) assess the amounts, timing and uncertainty of net cash inflows, and
3) understand the economic resources of an enterprise, the claims to these resources, and the effects of transactions, events, and circumstances that change the resources and associated claims.[4]

In addition, the information should be "understandable to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable due diligence."[5] In what follows, we take these definitions of reliability and relevance as a starting point from which to assess the quality of the nonprofit financial reporting model and alternative regimes.

## II. Financial Reporting in the Nonprofit Sector

The current nonprofit financial reporting model originated from required annual federal tax filings. The heterogeneity in the information demanded by the user community has generated substantial variation in the underlying accounting systems, disclosure requirements and oversight and monitoring throughout the nonprofit community. To understand this reporting system, we begin with the diverse stakeholder community and their demand for information before discussing the reliability and relevance of the information supplied.

[3] The Governmental Accounting Standards Board (GASB) sets accounting practices for governmental organizations.
[4] *Statement of Financial Accounting Concepts No. 1*, pars. 5-8.
[5] *Ibid.*

1. User Communities

In the nonprofit sector, the stakeholders can be broken down into three main groups: clients who use nonprofit services, donors who provide charitable support, and the community that benefits indirectly from the services. Donors have an interest in nonprofit accountability to ensure that charitable resources are not siphoned off for non-charitable purposes, which would thwart the donor's charitable intent and the organization's stated mission. Clients care about nonprofit accountability because, in the absence of oversight, services may decline in quality or become too costly. Taxpayers and community members want accountability because their tax burden may increase if exemptions are granted to ineffective organizations or by government grants funding programs that are not productive for the community. Clearly, these three groups have varying agendas and are able to process information with different levels of expertise.

*Donors*. Many charities are dependent to a greater or lesser extent on contributed income. These "donative" nonprofits gather funds from foundations, corporations, federated funders, and individuals in order to carry out their charitable missions. Institutional funders have long studied the financial statements of nonprofits during the grant review process. At times, some foundations have been demanded special financial controls or management reforms in the organizations that they fund. This oversight is limited in impact and scope, however, since most charitable giving is done by individuals not institutional givers. Individual contributions are a means for donors to support causes that reflect their own values and personal commitments. Research indicates that many individual contributors contribute to organizations with which they have had personal contact, including universities they have attended, hospitals that have improved their families' health, churches that have guided them spiritually, and arts organizations that have entertained them (Odendahl 1990; Ostrower 1994). Due to these personal considerations and the lack of access to information, many individuals do not consider a charity’s financial statements in making their contribution decisions (Gordon and Khumawala 1999).

*Clients*. Over the past two decades, earned income – revenues derived from client fees or commercial ventures – has quietly become a critical engine of growth in the nonprofit sector. While some parts of the sector depend on charitable contributions, the majority of nonprofit organizations today rely on revenue that is derived from fees and other commercial activities. The dependence on fees and ventures exposes nonprofit organizations to market pressures, including client satisfaction. From the community mental health centers that offer services on a sliding scale based on income to a boarding school that charges tuition and sells sweatshirts and coffee mugs to alumni, more and more charities have clients that look and act like customers. Although commercialization in the nonprofit sector has made clients more inquisitive about the price, selection and quality of the services they purchase from nonprofits, few clients ask tough questions or do much research before using nonprofit services.

*Community*. Within neighborhoods and communities, public charities are often viewed as critical resources, particularly where business investment is low and public programs are lacking. Even in organized and politically engaged communities, few residents watch over the local nonprofits with a sense of ownership. Some community members may become involved in an organization by serving on an advisory board or volunteering in a particular program. Nevertheless, it is rare for members of the general public to actively oversee the operations of nonprofit organizations operating in their community. Communities benefit indirectly from charities, but rarely do they demand a community impact statement or attempt to scrutinize the agency's programs or finances.

The three main stakeholder groups thus have different reasons for caring about nonprofit performance and accountability. At present, however, few stakeholders from the three groups actively seek out and use information on nonprofit finances, though the idea of nonprofit accountability clearly has traction. A critical challenge in reengineering nonprofit accountability begins therefore with transforming the demand for information from its current latent form to a more active one.

### 2. Internal Accounting Systems

Many nonprofit organizations are relatively small, mission-focused, and often cash constrained. As a result, these firms operate with modest internal accounting staffs. In smaller organizations, volunteers may serve as part-time bookkeepers while a paid program staff member may be assigned to financial planning. The accounting records are frequently maintained on inexpensive, easy-to-use software packages, such as Quicken, that were not designed for the challenges of nonprofit accounting and leave no audit trail. Some nonprofits maintain cash-basis records during the year and hire a part-time consultant or external accounting (EDP) service to convert the books to an accrual basis and close the annual books. Small staffs limit the ability of most nonprofits to maintain an adequate internal control system.

When new grants are received, the external demands for information often change. Since funding is often a short term, the accounting systems are modified to meet current reporting needs, resulting in a error prone, hybrid manual-computerized accounting system that includes different bases of accounting and duplication of effort. Nonprofits with endowments or more reliable funding sources are less affected by these swings in funding. If a change does occur, these organizations are able to respond by hiring more grant administrators and by upgrading to more sophisticated accounting systems. Ultimately, only a small number of well-financed organizations are able to avoid the problems that beset the majority of more financially constrained organizations.

### 3. Financial Disclosure Requirements

The heterogeneity of users has resulted in a plethora of financial disclosure requirements. First, nonprofits must obtain tax exemption from the IRS and the appropriate state authority by filing registration statements. Then, most nonprofits are subject to annual Form 990 tax filings. Nonprofit organizations (except religious organizations) with over $25,000 in annual revenues must file Form 990s annually with the Exempt Organization Division of the IRS. Over time, the IRS has sporadically examined the forms,[6] but focused more on making the forms publicly available. Nonprofits must make available the last three IRS filings on a same-day basis and for a reasonable copying charge to anyone requesting in person or by mail.[7] Nonprofits are free from this requirement if they make their 990s "widely available" via the World Wide Web.

The lack of reliability and relevance of the filings has been an issue, however. First, filings are not useful because they are often one to two years out of date. The data is

[6] Gordon, Greenlee and Nittenhouse (1999) report a 2.09% examination rate for nonprofits in 1994 as compared to 2.05% and 1.67% for corporate and individual filings, respectively.
[7] Internal Revenue Bulletin 1999-17. The final regulations on disclosure requirements are T.D. 8818 and are described at: http://www.irs.gov/prod/bus_info/eo/topico00.pdf.

stale because nonprofits are not punished for filing late and because extensions are readily granted. Moreover, the infrastructure necessary for making IRS filings quickly available does not presently exist. Second, the typical Form 990 is riddled with mistakes and goes unverified. Nonprofit advocacy groups complain that 990 Forms typically contain high rates of mathematical errors, transposed digits, omitted information, and information inserted on the wrong lines (Qual990, 2000). The IRS reports that over one-third of filings fail to include the Schedule A, about one-fifth are not signed, and one-tenth indicate the wrong tax year. The research community has reinforced these assertions and warned users about the potential limitations of the information (Abrahmson 1995; Orend, O'Neill & Mitchell 1997; Gordon, Greenlee, and Nittenhouse 1999). Third, the Form 990 fails to conform to GAAP (Froelich and Knoepfle 1996, Froelich, Knoepfle and Pollack 2000). Table 1 outlines the key differences between the Form 990 and audited financial statements. Nonprofits that take advantage of these discrepancies are able to portray themselves as having more efficient operations than organizations that operate under the more conservative GAAP principles.

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Insert Table 1 about here

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The problems of timeliness, lack of verification and bias may become increasingly problematic as 990 Forms become more available. Knowing that the Form 990 will be presented alongside new on-line giving programs, charities may increasingly be tempted to engage in selective or misleading disclosures to increase contributions. Whether donors are or have been misled has not been extensively studied and the evidence to date points in different directions depending on whether the information being considered is audited or simply reported on the Form 990.[8]

To address the concerns with the Form 990, many states, federal grantmaking agencies, and institutional donors require that nonprofits provide supplemental disclosures, primarily audited financial statements. The GAAP rules for preparing audited nonprofit financial statements have evolved over the past 15 years, making these financial reports more comprehensive as well as transparent to users than the Form 990. Nonprofits are now required to capitalize and amortized new capital expenditures, similar to for-profit business (SFAS #93).[9] The financial statements now reflect multi-year funding commitments and more clearly depicted restrictions placed by donors on firm resources (SFAS #116 and #117). In addition, a cash flow statement revealing the magnitude and nature of net cash outflows and inflows became required. Accounting for investment securities using their fair market value (rather than historical value) became mandated (SFAS #124), which meant that the organization's total assets and equity would fluctuate with the volatility in any investment portfolio. Finally, the new nonprofit GAAP standards require federated fundraising organizations, community foundations and other related groups to reflect resources collected from the public with the purpose of redistribution to other nonprofits as liabilities rather than firm revenues (SFAS #136). By

[8] Tinkelman (1999) found that subsequent donations increase for nonprofits that report better efficiency ratios (large program expenses relative total expenses) in their audited financial statements. Frumkin and Kim (2000) found that organizations reporting lower ratios of administrative to total expenses on the Form 990 did not receive significantly higher amounts of private support than organizations reporting less efficient operations.

[9] Nonprofits, such as museums, were encouraged but not required to reflect previously expensed fixed assets. As a result, current GAAP statements may substantially understate an organization's fixed assets and equity.

changing the accounting quality, the five new accounting standards have dramatically altered the information provided to the public.[10]

Before looking at federal requirements, it is important to note that there has long been considerable variation in the amount of state oversight of nonprofit finances. Along with the state form, nonprofits may be required to file audited financial statements with the state once an asset, revenue, or federal funding threshold has been exceeded. Table 2 outlines the supplemental disclosure requirements by state. In 1997, the National Association of State Charities Officials and the National Association of Attorneys General began a project to standardize, simplify, and economize compliance under the states' solicitation laws. Today, nonprofits can file either the unique state forms or the Unified Registration Statement (URS) with 33 jurisdictions (32 states plus the District of Columbia).[11] Several states, notably California, Maryland and Minnesota, have created searchable web-databases that permit users to obtain state filing information on nonprofits registered in the state.

Insert Table 2 about here

The federal government has adopted different supplemental requirements. Since January 1, 1990, nonprofit organizations receiving substantial direct or indirect federal assistance are subject to even more stringent auditing requirements than GAAP under the

[10] While the FASB implemented these changes to improve the quality of financial reporting, industry members and some academics have questioned their merits (Anthony 1995).
[11] The Uniform Registration Statement is downloadable from: http://www.nonprofits.org/library/gov/urs/ursweb_v211.pdf.

Single Audit Act.[12] The Office of Management and Budgets (OMB) has issued several circulars (A-110 and A-133) and amendments that outline the audit procedures, guidelines for allowable costs (that can be charged to federal grants) and designate "cognizant" federal agencies to which the auditor's compliance reports are to be directed. These audits supplement traditional CPA audits with two sets of procedures: general requirements that apply to all auditees and specific requirements that are based on the program-funding source. The procedures are designed to ensure that nonprofits comply with statutory and regulatory requirements and fulfill the unique requirements of particular grant programs. As a result, A-133 and A-110 audits include auditing the operational activities of the organization as well as the accounting system. These audits are costly since a CPA must have additional training, conduct more extensive tests, prepare supplemental schedules and reports, and assume greater potential liability.

The current financial reporting system for nonprofits, however, does not offer this fuller disclosure to all stakeholders. Rather it requires nonprofits to make the less reliable and relevant Form 990 readily available to the public, while leaving the preparation and disclosure of the more conservative audited financial reports to the discretion of the vast majority of nonprofits.

### 4. Oversight and Monitoring

Donors, clients and communities do not have the legal standing to sue nonprofit organizations for misuse of funds or misleading reporting. Instead, they must rely on an organization's board and government regulators. While the IRS or the state attorney generals' offices have the ability to prosecute, they have not historically had the resources

[12] The annual revenue threshold for a A-133 or A-110 audit has increased over time to $250,000.

or inclination. Before 1996, the primary oversight tool was the IRS's ability to deny a new organization tax-exempt status. This tool was infrequently used, with only 520 of 46,887 applications denied in 1994 (Hawks 1997).

For years, the IRS imposed only one penalty on existing charities that were engaging in questionable financial dealings: it would revoke the tax-exemption of an organization. The primary reasons for this action were employee fraud or illegitimate compensation practices. Employees that commit fraud are often quietly terminated. Given the difficulty of determining these problems, the IRS rarely used its revocation power. Occasionally, the IRS entered into closing agreements with charities to resolve conflicts over the use of charitable resources. Recently, new "intermediate sanctions" were enacted to penalize nonprofits that pay excessive compensation and the IRS has published new regulations that clarify both the definition of insider and describe its process for compensation comparison and evaluation (Frumkin and Andre-Clark 1999; Frumkin 2000). Most significantly, the intermediate sanctions penalty, a targeted excise tax, is designed to give the IRS a moderate penalty that will allow enforcement actions without the extreme remedies of exemption revocation or closing agreements. The new sanctions, however, do not apply to or penalize nonprofits that engage in fraudulent or misleading reporting.

Beyond oversight by the IRS, nonprofits are also scrutinized by a growing number of information intermediaries and rating services. Seeking to address the lack of active use of information about nonprofit organizations, several independent agencies have emerged to rate and evaluate nonprofit organizations, including the National Charities Information Bureau (NCIB) and the Philanthropic Advisory Service of the

Council of Better Business Bureau. Both agencies evaluate organizations based on audited financial information (rather than the Form 990), data on corporate governance and additional explanatory information on program services. Beyond these efforts, there is at least one major development on the horizon that may make information easier to locate and use. A new nonprofit-sponsored project has been formed to provide financial information on nonprofits over the Internet. The goal of the project is to increase charitable giving by making Form 990 information available to the average donor together with an on-line giving program. When complete, the Guidestar web site will offer summarized financial data including operating expenses, administrative overhead, and fund raising costs, on a large number of nonprofit organizations as well as scanned copies of the Form 990.

In sum, as it is now structured, the nonprofit financial reporting system is based largely on the IRS Form 990, which has been shown to be a unreliable and often irrelevant source of information. With the exception of private institutional funders and government contractors, nonprofit stakeholders have adopted a passive approach to nonprofit accountability. Further exacerbating these problems, enforcement and oversight of the system is minimal. These problems lead one to ask how alternative accountability systems are constructed and how the nonprofit sector might learn from these other systems.

## III. Alternative Reporting Frameworks in the United States

In searching for models that might be relevant to the nonprofit situation, we compiled a list and gathered background information on a range of reporting systems. A number of these systems were designed to generate detailed financial reports primarily for a regulatory audience.[13] However, we identified two systems -- those overseen by the Securities and Exchange Commission (SEC) and the National Credit Union Administration (NCUA) -- that provided data to the public that were more detailed, easier to access, and more readily analyzed than the IRS Form 990 information. We describe below these two systems and highlight their differences with the existing nonprofit framework, all with the goal of finding practices and policies that might be transferable to the nonprofit sector.

### *A. The Securities and Exchange Commission and Publicly Traded Firms*

Following the stock market crash of 1929, the US Congress passed two acts that created the crux of the financial reporting system for the publicly traded firms. The Securities Exchange Act of 1934 (the 1934 Act) created the Securities and Exchange Commission, while the Securities Act of 1933 (the 1933 Act) required issuers to file registration statements with the Commission before offering their securities to the public. The business-reporting model was and still is driven by demand from the investment community for reliable information. Without capital from equity investors and creditors, most publicly traded firms would cease to operate. As a result, firms spend considerable resources operating their internal accounting system, hiring external auditors, paying filing fees to fund the Securities and Exchange Commission, and providing information directly to investors and Wall Street. Today, the financial reporting system for US publicly traded firms is the most comprehensive and expensive system in the world. The

[13] For example, financial institutions must file "call" reports with various financial regulators. Public utilities file detailed reports with the Federal Energy Regulatory Commission (FERC).

system generates detailed and timely reports that allow extensive time-series and cross-sectional analyses of firms.

1. Internal Accounting Systems

Due to the high demand for information, publicly traded firms have relatively large accounting departments that invest in sophisticated computerized accounting systems and have well-developed systems of internal control. Annually, the firms are required to be audited by an independent external CPA, who issues an opinion on whether the financial statements accurately represent the financial condition of the firm. Most firms also hire internal auditors to test internal control systems and evaluate the effectiveness various operations. To ensure their independence, these employees, as well as the CPAs, usually report directly to an audit committee, composed of independent members of the Board of Directors.

2. Financial Disclosure Requirements

The stock market crash of 1929 and ongoing high expectations of stakeholders has led to substantial financial disclosure requirements. Prior to issuing a new security, firms must file a registration statement with the SEC disclosing a description of the company's properties and business, a description of the security to be sold, information about the management of the company, and audited financial statements. Other mandated non-financial disclosures are considerable (see Table 3). The SEC requires annual as well as quarterly reporting of financial statements (Forms 10-K and 10-Q, respectively) of companies with publicly traded securities if their size exceeds $10 million in assets and the securities are held by more than 500 owners. In addition, firms must file additional statements prior to issuing new securities, to announce substantial changes in ownership, tender offers, mergers and acquisitions. While the annual financial statements are audited, all reports must be prepared in compliance with GAAP. Forms 10-K and 10-Q are required within 90 and 45 days of period-end, respectively, while filings outlining substantial events must generally be provided with 10 days.

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Insert Table 3 about here

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Most SEC filings are made available to the public within 48 hours of filing at the SEC reference rooms around the country. Until the mid-1990s, several information vendors specialized in collecting filings as soon as they became available and reselling these filings to investors. Most public filings since 1995 have been loaded into the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system and made available in free downloadable form at the SEC web site.[14] Since 1996, the SEC has required that registrants submit most forms electronically using the EDGARLink filer assistance software. The software is used to create, check, and transmit their disclosure reports ("filings") to the SEC. The EDGARLink system allows automated collection, validation, indexing, acceptance, and submission of required filings. The SEC states that the system's primary purpose is to increase the efficiency and fairness of the securities market for the benefit of investors, corporations, and the economy by accelerating the receipt, acceptance, dissemination, and analysis of time-sensitive corporate information filed with the agency. Numerous free websites have emerged (FreeEdgar, 10KWizard,

[14] See http://www.sec.gov.

and PriceWaterhouseCooper's EdgarScan) that draw timely data from the Edgar system and create user-defined comparative analyses of financial statements.

Financial reporting is not limited to SEC filings. Publicly traded firms are required to mail an annual report, proxy statement, and voting materials to each shareholder. The annual report includes an opening letter from the Chief Executive Officer, the audited financial statements, a detailed management and discussion and analysis of the year's operations, market segment information, new product plans, subsidiary activities and research and development activities on future programs. Prior to the annual meeting of shareholders, firms must file a proxy statement describing upcoming the issues related to shareholder resolutions, executive compensation and profile of board of directors.

The cost of financial disclosure by publicly traded firms is substantial. The firms are responsible for covering the costs of their internal audit staffs, the external audit, production and distribution of the annual report and proxy statement. In addition to these costs, firms also fund the SEC's entire operating budget of $377 million in 2000 through filing fees.

3. User Community

A wide range of stakeholders rely on financial disclosures by publicly traded firms, including investors, creditors, suppliers, employees, customers, and local communities. Due to the concentration of financial wealth associated with publicly traded firms, the user community has an active interest in assessing financial statements. To assist the users in analyzing accounting quality and firm performance, a large industry has emerged to assist stakeholders in analyzing financial statements. Wall Street brokerage firms offer investors equity and bond research reports. Rating agencies, such as Moody's and S&P, establish bond ratings on publicly traded debt. Financial planners advise individuals on managing their pensions and other investment dollars. Finally, numerous information providers sell data and research articles directly to the public.

### 4. Oversight and Monitoring

The SEC is empowered with extensive oversight authority by Congress. The SEC can prescribe accounting practices and standards but has traditionally supported the private sector's standard setting bodies, such as the FASB and GASB. In 1997, it processed over 12 million pages of information from over 28,000 corporate, investment company and individual filers. In addition to receiving, analyzing and disseminating filings, the SEC regulates agents that handle funds on behalf of investors and firms. These agents include brokerage firms, transfer agents, clearing agencies, and securities self regulatory organizations (SROs), such as the New York Stock Exchange, American Stock Exchange, and the National Association of Securities Dealers.

Despite its information dissemination and examination functions, the SEC is primarily a law enforcement agency. The SEC issues guidance and counseling to registrants, prospective registrants, and the public to help them comply with the law. It issues no-action letters to issue guidance in a more formal manner. The Division of Enforcement investigates possible violations of securities laws. In 1997, it responded to over 50,000 complaints and inquiries, conducted over 400 investigations, and engaged in over 200 administrative proceedings and over 200 civil proceedings. While the SEC has only civil enforcement authority, it does bring criminal cases when the misconduct warrants more severe action.

Is the SEC approach a panacea for what wrong with nonprofit reporting system? It probably is not. Some aspects of the system are simply too costly. Other parts are overly complex. Moreover, even with this extensive system, publicly traded firms still unexpectedly enter bankruptcy, employees occasionally perpetrate fraud, and shareholders lose money due to fraudulent and misleading financial reporting. Still, the SEC model has strengths from which any new nonprofit model can take some lessons. In particular, the system benefits from the presence of an active and engaged regulatory body, a set of consistent reporting categories, a powerful dissemination infrastructure, and an active stakeholder community. We return to these features in the conclusion.

### *B. The National Credit Union Administration and Credit Unions*

In contrast to publicly traded firms, credit unions are relatively small, tax-exempt cooperative organizations. Credit unions started in New England in 1909 as a social movement designed "to make more available to people of small means credit for provident purposes" (Federal Credit Union Act [1982]). Today, the approximately 11,000 federally insured credit unions are a major source of consumer finance, serving over 70 million members (37% of the US adult population) (CUNA [1997]). While credit unions constitute 50% of US financial institutions, they compose 2% of US financial assets and hold 8% of total banking deposits. The credit union industry has a well-developed financial reporting system that provides detailed and timely reports and allows time-series and cross-sectional analysis of the entire credit union population. This financial reporting system is facilitated by the relatively homogeneous information demands of the stakeholders, active investment by one party (the key regulator) in developing the financial reporting infrastructure, and a consensus over the desirability of having a reliable and relevant reporting system.

1. Internal Accounting Systems

Similar to nonprofit organizations, credit unions have limited internal accounting staffs. In many small credit unions, credit union members serve as part-time volunteer bookkeepers. For credit unions based on occupational ties, an accountant or bookkeeper employed at or retired from the affiliated firm will provide accounting services *pro bono*. The credit union may also hire a part-time consultant or external accounting (EDP) service to do the more challenging bookkeeping tasks. With increased size, credit unions hire trained accounting professionals. In 1997, 4.5% of credit unions still employed manual rather than computerized accounting systems.

2. Financial Disclosure Requirements

The keystone of the credit union financial disclosure is the "5300" Call Reports. By law, credit unions are required to file either semi-annual or quarterly regulatory filings with the National Credit Union Administration (NCUA), the federal regulator. The filings can be prepared in accordance with either credit union regulatory accounting principles (RAP) or GAAP. The call report requires credit unions to supplement the financial statements with descriptive detail about its operations to help users better analyze the firm’s performance (see Table 4). The NCUA requires that credit unions file their returns promptly. For example, quarterly and semi-annual call reports are due in less than four weeks.

Insert Table 4 about here

Credit unions are strongly encouraged to file their call reports electronically using PC 5300, a free Windows-based application downloadable from the NCUA website. The free software provides several benefits: First, the program includes extensive descriptions of the datafields and required contents. Second, program identifies errors, such as missing fields, incorrect summations, etc. and provides text-sensitive help to correct the mistake. All errors must be corrected before the filing can be finalized. Third, the program creates an electronic transmission file that is sent to the NCUA host computer for subsequent statistical analysis, reporting, and processing. The transmission reports allow filings to be more easily analyzed individually or collectively by the NCUA and made publicly available in electronic format.

The 5300 reports are the starting point for any regulatory examination but are also accessible to the public. The 5300 reports of an individual credit union can be viewed on web starting with the June 1990 filings. The filings can be sorted and searched using most datafields in the 5300 report and are extractable into comma-delimited text files. Under the Freedom of Information Act (FOIA), any person can download the complete 5300 filings of all federally insured credit unions from the NCUA website[15] in spreadsheet format starting with the June 1994 filings. This data is publicly available within 6-months of period-end.

[15] See http://www.ncua.gov/data/FOIA/FOIA.html.

Financial reporting is not limited to filing the call report. Credit unions are legally required to post in the lobby of their branches "counter reports" of their balance sheets, income statements and selected loan, deposit and investment information based on the 5300 call reports. Warfield and Henning (1994) surveyed a stratified sample of credit unions on their financial disclosure behavior in the 1987-92 period. They found that 52% mailed the counter reports to their members, and 21% provided more comprehensive financial reports, often prepared in accordance with GAAP. While financial statements are disseminated to members, the Warfield and Henning study indicates that management, regulators and the board appear to be the most important users.

The cost of operating NCUA are covered entirely by the credit union industry, and the NCUA receives no subsidies from the government. The financial reporting and examination functions of NCUA are funded by operating fees charged to credit unions based on a sliding scale. Most credit unions pay about 00.03% of total assets per year. The bulk of this money goes to field examiners, so costs attributable to financial reporting are relatively low. The Warfield and Henning study estimated that the average cost of *all* accounting and financial reporting costs for their sample was $117,300, equaling 4.75% of equity. These costs included accounting staff (no cost estimate), operating fees (no cost estimate), outside accounting services (EDP) of $33,500, producing and distributing reports of $2,720, and external audits averaging $10,200.

3. User Community

Beyond the members and the NCUA, there is a relatively small audience for credit union financial information. Although depositors do not rely on this information, commercial banks and thrifts scrutinize credit unions' financial statements to glean competitive information. Over 99% of all credit unions purchase bonding insurance from CUNA Mutual, a mutual insurance. As a result, CUNA Mutual conducts their own financial analysis including some site visits of credit unions. Finally, academics and credit union associations conduct research on credit unions to better understand credit markets. This system has been successful in building trust and confidence in credit unions.

4. Oversight and Monitoring[16]

To compensate for the weak internal accounting systems, the credit union industry is subject to oversight by the two key user groups: credit union members and the financial regulators. The individual members have little direct oversight, rather each member is entitled to a single vote in the election of board members, and members can redeem their deposits from the credit union with interest on demand. Collectively the members assert oversight through a supervisory committee, which is appointed by the board from the credit union membership and oversees not only a required annual "audit" but also a biennial verification of member accounts. Most credit unions choose between three levels of audit quality. At the lower end of cost and quality, the credit union can "self-audit," using the volunteer work of its supervisory committee supplemented by credit union employees or volunteers. As an alternative, a credit union can choose an intermediate level of audit quality by hiring (or receiving *pro bono)* the services of a non-independent or non-CPA outsider. At the high end, a credit union can employ a CPA to complete an independent opinion audit. If a CPA provides an opinion audit, then he is required to

[16] For detail on the role of auditing, see Keating (1999) and (2000).

follow generally accepted auditing standards (GAAS) and present the audited financial statements in accordance with generally accepted accounting principles (GAAP).[17]

The primary regulator of credit unions is the National Credit Union Administration (NCUA). Since its establishment in 1970, its overall goals have been to protect the deposit insurance fund and maintain the solvency and liquidity of the credit union system. The NCUA responsibilities are to charter, examine, supervise and provide deposit insurance to credit unions. Today, the NCUA regulates and insures all federal and most state chartered credit unions. Credit unions receive annual on-site examination from NCUA or state regulatory examiners, who look for threats to the financial viability of an institution, compliance with laws and regulations, and poor management. Poor examination results can lead to regulatory supervision or ultimately to removal of managers or volunteers, termination of deposit insurance, financial assistance, a merger or liquidation (CUNA 1997). These supervision and enforcement actions are announced publicly through NCUA press releases.

We see in the credit union financial reporting system some important lessons for the broader nonprofit community. This self-financed system uses technology well, has clear accounting standards, and an active coordinating and enforcement agency. Though less elaborate and user-oriented than the SEC model, credit unions have developed a system whose scale and costs are more in line with those that are appropriate for the broader nonprofit sector.

[17] In the pre-1998 period, independent CPA audits were only required by the NCUA if: (1) the supervisory committee had not conducted an annual audit, (2) the supervisory committee's audit failed to meet the NCUA's requirements, or (3) the credit union had serious and persistent recordkeeping deficiencies (12 C F R § 701.12 (a)). Due to new 1998 legislation federally insured credit unions with assets of $500 million or more or are required to have audits.

## IV. A New Direction for Nonprofit Accountability

This paper has taken a broad perspective to the issue of nonprofit accountability, assessing not only the quality of the financial data, but also the entire financial reporting framework. In conclusion, by gleaning ideas from the SEC and NCUA models, we present six policy proposals for improving nonprofit accounting and reporting, starting with modest improvements that can be made quickly and building to more ambitious options for overhauling the system. It is important to make clear that we see no need to implement all of these recommendations at one time. We would recommend a graduated approach to making changes in the nonprofit accountability system, as stakeholders become more active and engaged in using data on nonprofit financial performance. Still, there are several steps that can be taken to get the reengineering process underway.

First, the Internal Revenue Service should revise the 990 forms to conform with generally accepted accounting standards (GAAP) and encourage dissemination of audited financial statements. In the meantime, active stakeholders can follow the lead of government agencies and institutional funders by requiring nonprofits to provide audited financial statements, whenever possible, in addition to 990s. Smaller organizations should be encouraged to voluntarily file tax returns. By providing this information to stakeholders, the nonprofit community will improve the understanding of individual organizations, enhance the allocation of resources within the community, and better achieve nonprofit accountability. Just as only nonprofits with a minimum of $25,000 in revenues are required to file a 990 form, a reasonable cut-off could be established for the preparation of audited financial statements. Right now there is considerable uncertainty in the accuracy of the information reported in the 990 forms. Stakeholders need assurance that the financial data, particularly as it relates to executive compensation, administrative overhead, and other non-program expenditures are reported consistently and accurately. Moving to a system that requires GAAP accounting and the use of audited financial statements would be a first step in improving reliability and relevance.

Second, information technology now makes it possible for this information to be shared much sooner and more broadly. There is no compelling reason that tax filings could not be filed electronically by nonprofit organizations and quickly posted on the web. Public-private partnership could develop downloadable software for creating and submitting the tax filings as well as the infrastructure for receiving and posting these filings. At least, one initiative is already underway to make electronic filing possible. The NCUA system would be a good point of departure for the design of a filing system for the nonprofit sector.

Third, education and public information could improve stakeholders' understanding of the importance of financial reporting to sensible performance assessments. A public information campaign could raise awareness of differences in nonprofit operating practices and impress on donors, clients and communities the importance of being informed about nonprofit organizations they support directly or indirectly. The SEC model rightly focuses on dissemination and use of data for decision making. Even though much of the private support that fuels charitable activity is conveyed without rigorous standards, public information and awareness could only improve the allocation of resources to the nonprofit community and encourage better nonprofit management. We therefore believe that a broad initiative aimed at activating stakeholders would be critical to any successful reengineering of nonprofit accountability.

Fourth, more relevant disclosures should be provided to stakeholders. In particular, management discussion and analysis (MD&A) and indicators of program activity could be included in the financial reports. Financial measures may effectively capture the key risk and return measures of for-profit organizations. However, the value added of nonprofits is not measured by the dollars spent on program services, but rather in the reach of its programs. While measuring impact and effectiveness remains difficult, there are proxy measures of program activity that can still be collected and disseminated. Encouraging more extensive disclosure of program rationale, inputs (e.g. names of donors and number of employees and volunteers), and outputs (e.g. number of clients served and hours of service delivered) would be a useful first step.

Our fifth recommendation recognizes that providing more extensive and reliable information more quickly may be insufficient. The amount of financial reporting by publicly traded firms and extensive SEC enforcement activities demonstrate an important point: Even the best financial reporting system alone can not prevent fraud and fraudulent reporting. Whenever substantial amounts of money are involved, abuses are likely to occur. The nonprofit sector now constitutes 12% of the US economy and 10% of the workforce and continues to grow. For this reason, greater coordination the nonprofit financial reporting system is necessary and may require a new organization. A range of organizational structures and powers are possible. This body could be a independent, self-regulating organization, like the FASB, New York Stock Exchange, or NASDAQ. It could be a quasi-independent government agency, like the Federal Reserve system. Alternatively, it could be an intergovernmental agency, such as the Federal Financial Institutions Examination Council that oversees regulatory filings and examinations of financial institutions. Finally, it could be a federal agency, such as the NCUA or SEC that could either work cooperatively with the IRS or subsume the responsibilities of the Exempt Organizations Division.

Once established, the new agency could be funded in one or more ways: The system could be funded with annual filing fees that are based on a sliding scale. This scale could range from $50 to 250 per year, and perhaps an initial application fee of $100. With 600,000 nonprofit filers with an average filing fee of $100, such a system would generate $60-65 million to launch a top quality information dissemination system. Alternatively, the system could be funded by a range of parties, including government agencies, foundations, corporations, and federated funders, which use this data in their decision making and evaluation of nonprofits regularly. While this approach would remove the costs from the nonprofit agencies, it would be difficult to support and sustain in the long run given the ever changing priorities of many funders. Another option would be to create an endowment to support this initiative, which could be funded by a combination of fees from the nonprofits and contributions from funders. A final option would be to attempt to finance the system by charging users who access the data a fee. This is the least workable of the options given the scale of the initiative and the fact that demand for the data must be stimulated and cultivated.

Sixth, we suggest that an independent commission be created to study the nonprofit reporting system and make recommendations for the new agency and its funding. While we are not recommending a specific organizational structure or duties for the new agency, the process by which this organization is formed is important. The present financial reporting system does not provide the reliable and relevant information that the stakeholders should demand, and nonprofit organizations are not held accountable for providing this type of information. These commissions have been successfully in the business setting. The Wheat

Commission led to the redesign of the standard setting process and the creation of FASB. More recently, the Jenkins Committee re-evaluated the business reporting model, leading to a greater emphasis on reporting of non-financial outcomes by businesses. The goal of the commission would be to develop a blueprint for an effectively operating nonprofit reporting system and new agency based on input from the stakeholder, regulator and nonprofit communities. The commission would design an implementation plan complete with recommended funding proposals. It would then work to develop a consensus behind its recommended plan and achieve implementation.

In constructing any new system for collecting and disseminating information on nonprofits, it will be critical to have nonprofit organizations actively involved in all aspects of the system's design. The experience of the credit unions is instructive in this regard. Their oversight system is popular among participants precisely because there is ample opportunity for input and control. Any new nonprofit accountability system must therefore be supported by the nonprofits themselves. This will entail convincing the sector that better information and more informed donors will strengthen support for nonprofits and generate greater levels of support in the long run.

By working simultaneously to improve the supply of nonprofit financial information and to stimulate demand for this information, a new nonprofit reporting agency – conveying data based on audited financial statements – could lay a strong foundation for the sector's continued growth. Improving the sector's accountability system will go a long way toward building the trust that nonprofits need to thrive in the growing space left open between the state and the market.

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**Figure 1**

**Financial Reporting System**

## Table 1

### Differences in Reporting Requirements Between the Form 990 and Audited Financial Statements

*Present in the Form 990 but not required for audited financial statements*

- Information on officers, directors and compensation
- Description of mission and program services (optional in audited financial)
- Responses to yes/no questions regarding compliance with various legal requirements
- Analysis of income-producing activities (used to determine if firm is fulfilling operational tests required to maintain exempt status)
- Ownership information on taxable subsidiaries

*Present in audited financial statements but missing from the Form 990:*

- Information on whether the statements are audited and received a qualified or unqualified opinion
- Accounting principles used to prepare the statements
- Description of the entity being audited
- Cash flow statement
- Amounts, timing and conditions associated with restricted funds

*Practices in the Form 990 that are not consistent with Generally Accepted Accounting Principles (GAAP):*

- The accounting method for many accounts are not disclosed in the 990
- Use of an indeterminate basis for allocating joint costs to program activities rather than to administrative or fundraising activities in Form 990
- Unrealized gains and losses on investments are reported in the Form 990 but are reflected in value of the investments and the equity in the audited financial statements
- Recognition of most contributed goods and services can not be included in the Form 990, while certain noncash contributions can be included in the audited financials
- Limited or no information is disclosed about revenues and expenditures associated with restricted funds are provided in the 990
- Indirect costs of selling merchandise (such as selling, general and administrative costs) can be included in cost of goods sold
- The 990 requires that nonprofits carry revenues from sales of merchandise, special events, and rental activities net of expenses as a gain/loss included in revenue rather than having the separate components shown in revenues and expenses. GAAP accounting allows netting of only for incidental or peripheral activities.

**Table 2**

**State Filing Requirements for Nonprofit Organizations**

*States that require audited financial statements along with 990 Forms for Registration and/or Annual Filing**

| | | |
|---|---|---|
| Alaska | Maryland | New York |
| Arkansas | Massachusetts | Pennsylvania |
| Connecticut | Michigan | Rhode Island |
| Georgia | Minnesota | Tennessee |
| Illinois | Mississippi | Utah |
| Kansas | New Jersey | West Virginia |
| Maine | New Mexico | Wisconsin |

*States that require only Form 990 for Registration and/or Annual Filing*

| | | |
|---|---|---|
| Alabama | Louisiana | Oklahoma |
| Arizona | Missouri | Oregon |
| California | New Hampshire | South Carolina |
| Florida | North Dakota | Washington |
| Kentucky | Ohio | |

*States that accept either a Form 990 or Audited Financial Statements*

| | |
|---|---|
| North Carolina | Virginia |

*States that do not require Charitable Reporting*

| | | |
|---|---|---|
| Colorado | Iowa | Texas |
| Delaware | Montana | Vermont |
| Hawaii | Nebraska | Wyoming |
| Idaho | Nevada | |
| Indiana | South Dakota | |

Source: http://www.nonprofits.org/library/gov/urs/o_appndx.htm
*States have varying thresholds in the amounts of charitable contributions solicited that trigger the need for audits.

**Table 3**

**SEC Mandated Financial Disclosures Beyond the Required Financial Statements**

*10-K and Proxy Filings to SEC:*

- Description of business, properties, and operations
- Information on size and type of investments in subsidiaries
- Number of employees
- Description of competition, regulatory environment
- Description of legal proceedings
- Description of risk management system
- Management Discussion and Analysis (MD&A) of financial condition and results of operations.
- Specifics of the executive compensation plan
- Profiles of senior management and directors of the board
- Stock holdings and related party transactions between the firm and top executives and directors

## Table 4

**SEC Mandated Financial Disclosures Beyond the Required Financial Statements**

*<u>Form 5300 Call Report of Credit Unions:</u>*

- Type of Supervisory Committee Audit (self, CPA without opinion, CPA with opinion audit, state credit union league audit, other external audit)
- Date of most recent supervisory committee audit
- Degree of computerization of accounting system
- E-Mail Address, Website, and Website vendor
- Number of current and potential members
- Pricing of loans by type and maturity
- Number of loans and individual borrowers by type of loan and maturity
- Number of delinquent loans and borrowers by type of loan and maturity
- Number of full and part-time employees
- Information on size and type of investments in subsidiaries